



USDA Foreign Agricultural Service

GAIN Report

Global Agriculture Information Network

Template Version 2.09

Required Report - public distribution

Date: 5/23/2006

GAIN Report Number: NZ6007

New Zealand

Dairy and Products

Semi-Annual

2006

Approved by:

David Rosenbloom
U.S. Embassy

Prepared by:

Alastair Patterson

Report Highlights:

New Zealand's milk production during the 2005/06 season (June-May) is now estimated at 14.9 million tons, 3 percent higher than the previous season. Exports of dairy products generally increased as a result. Fonterra is continuing to invest in increasing the rapid growth of demand for its dairy products in Asia, promoting dairy foods as a health supplement and adapting products to the Asian palate. In China, the government approved Fonterra's application to purchase a 43 percent share of Chinese dairy company San Lu.

Includes PSD Changes: Yes
Includes Trade Matrix: Yes
Semi-Annual Report
Wellington [NZ1]
[NZ]

SECTION I. EXECUTIVE SUMMARY

New Zealand's milk production during the 2005/06 season (June-May) is now estimated at 14.9 million tons, 800,000 tons above our initial forecast and 3 percent higher than the previous season. Post's estimate of New Zealand's dairy herd at the beginning of the 2005/06 season has been adjusted up to 4.1 million cows and heifers in calf or milk, a 3 percent increase over the previous season. The 2005/06 season was negatively affected by weather conditions. Production per cow was at a similar level to the previous season, which recorded a large drop in production from previous years. This decline in production per cow was offset by a 3 percent increase in cow numbers. As a result, milk production almost reached that of the record 2003/04 season.

Fonterra's international expansion continues. Fonterra is continuing to invest in increasing the rapid growth of demand for its dairy products in Asia by promoting dairy foods as a health supplement and adapting products to the Asian palate. In China, the government approved Fonterra's application to purchase a 43 percent share of the Chinese dairy company San Lu in April 2006. Fonterra views partnering with a local company as an assist in capturing a larger share of China's rapidly growing demand for dairy products. It also believes that gaining access to fresh milk supplies will complement its existing importing and consumer businesses. A proposed joint venture between Fonterra and Campina, a Dutch dairy company, was announced in March 2006. The joint venture will focus on improving the pharmaceutical lactose specialty of both companies. Fonterra and Dairy Management Inc (DMI) have signed a joint research agreement to promote the health and nutritional benefits of dairy. The research will help create competitive advantage for dairy products over competing protein based products and substantiate product claims.

A private equity group, Dairy Investment Fund Limited (DIFL), is offering to lend New Zealand dairy farmers the value of their investment in Fonterra. In exchange for the loan, the equity group will receive the value-added share of the milk price, as well as increases in the value of the shares. Farmers will receive the commodity milk price and use the capital for alternative investments. Farmers retain ownership of the shares and voting rights. DIFL is also offering a milk price derivative. Farmers have the opportunity to enter into a contract with DIFL at the beginning of the season at a set price for the final payout per kilogram of milk solids.

A new industry body, Dairy 21, was created in late 2005 with the aim to increase the productivity of New Zealand's dairy farms by 4 percent per annum. The aim of the group is to identify important objectives for New Zealand's dairy industry so they can be targeted in a consistent, industry-wide manner. Dairy 21 has also approached the New Zealand government for additional funding for research in the dairy sector. Dairy 21 currently has no direct funding and membership in the organization is voluntary. Members of Dairy 21 include Dexcel, AgResearch, Livestock Improvement Corporation, Fonterra, Westland Milk Products and the Dairy Companies Association of NZ.

SECTION II. STATISTICAL TABLES
PS&D TABLES

New Zealand Fluid Milk						
	(1000 HEAD)(1000 MT)					
	2004	Revised	2005	Estimate	2006	Forecast
	USDA Official Post Estimate	USDA Official Post Estimate	USDA Official Post Estimate	USDA Official Post Estimate	USDA Official Post Estimate	USDA Official Post Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin	06/2003		06/2004		06/2005	
Cows In Milk	3920	3920	3970	3970	4000	4100
Cows Milk Production	15000	15000	14400	14500	14100	14900
Other Milk Production	0	0	0	0	0	0
TOTAL Production	15000	15000	14400	14500	14100	14900
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	0	0	0	0	0
TOTAL Imports	0	0	0	0	0	0
TOTAL SUPPLY	15000	15000	14400	14500	14100	14900
Intra EC Exports	0	0	0	0	0	0
Total Exports	50	50	55	55	50	50
TOTAL Exports	50	50	55	55	50	50
Fluid Use Dom. Consum.	360	360	360	360	360	360
Factory Use Consum.	14545	14545	13940	14040	13645	14445
Feed Use Dom. Consum.	45	45	45	45	45	45
TOTAL Dom. Consumption	14950	14950	14345	14445	14050	14850
TOTAL DISTRIBUTION	15000	15000	14400	14500	14100	14900
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	0	0	0	0	0	0

Sources (All Data): Ministry of Agriculture and Forestry, Statistics New Zealand, Livestock Improvement Corporation, Post Estimates.

New Zealand Butter						
	(1000 MT)					
	2004	Revised	2005	Estimate	2006	Forecast
	USDA Official	Post Estimate	USDA Official	Post Estimate	USDA Official	Post Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin		06/2003		06/2004		06/2005
Beginning Stocks	31	70	21	40	49	40
Production	390	370	345	321	330	340
Intra EC Imports	0	0	0	0	0	0
Total Imports	0	0	1	1	1	1
TOTAL Imports	0	0	1	1	1	1
TOTAL SUPPLY	421	440	367	362	380	381
Intra EC Exports	0	0	0	0	0	0
Total Exports	374	374	292	296	305	315
TOTAL Exports	374	374	292	296	305	315
Domestic Consumption	26	26	26	26	26	26
TOTAL Use	400	400	318	322	331	341
Ending Stocks	21	40	49	40	49	40
TOTAL DISTRIBUTION	421	440	367	362	380	381
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	29	29	28	28	30	30

New Zealand Cheese						
	(1000 MT)					
	2004	Revised	2005	Estimate	2006	Forecast
	USDA Official Post	Estimate	USDA Official Post	Estimate	USDA Official	Post Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin	06/2003		06/2004		06/2005	
Beginning Stocks	36	45	29	35	36	35
Production	308	305	300	291	295	290
Intra EC Imports	0	0	0	0	0	0
Total Imports	2	2	2	2	3	3
TOTAL Imports	2	2	2	2	3	3
TOTAL SUPPLY	346	352	331	328	334	328
Intra EC Exports	0	0	0	0	0	0
Total Exports	289	289	267	265	280	265
TOTAL Exports	289	289	267	265	280	265
Human Dom. Consumption	28	28	28	28	28	28
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	28	28	28	28	28	28
TOTAL Use	317	317	295	293	308	293
Ending Stocks	29	35	36	35	26	35
TOTAL DISTRIBUTION	346	352	331	328	334	328
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	41	41	32	32	30	30

New Zealand Dry Nonfat Milk Powder						
	(1000 MT)					
	2004	Revised	2005	Estimate	2006	Forecast
	USDA Official Post	Estimate	USDA Official Post	Estimate	USDA Official Post	Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin	06/2003		06/2004		06/2005	
Beginning Stocks	70	60	55	25	80	25
Production	294	274	250	225	230	234
Intra EC Imports	0	0	0	0	0	0
Total Imports	1	1	1	1	1	1
TOTAL Imports	1	1	1	1	1	1
TOTAL SUPPLY	365	335	306	251	311	260
Intra EC Exports	0	0	0	0	0	0
Total Exports	305	305	221	221	226	230
TOTAL Exports	305	305	221	221	226	230
Human Dom. Consumption	5	5	5	5	5	5
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	5	5	5	5	5	5
TOTAL Use	310	310	226	226	231	235
Ending Stocks	55	25	80	25	80	25
TOTAL DISTRIBUTION	365	335	306	251	311	260
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	1	1	1	1	1	1

New Zealand Dry Whole Milk Powder						
	(1000 MT)					
	2004	Revised	2005	Estimate	2006	Forecast
	USDA Official Post	Estimate	USDA Official Post	Estimate	USDA Official Post	Estimate
	[Old]	[New]	[Old]	[New]	[Old]	[New]
Market Year Begin	06/2003		06/2004		06/2005	
Beginning Stocks	63	110	53	70	118	70
Production	658	628	650	585	642	585
Intra EC Imports	0	0	0	0	0	0
Total Imports	2	2	1	1	1	1
TOTAL Imports	2	2	1	1	1	1
TOTAL SUPPLY	723	740	704	656	761	656
Intra EC Exports	0	0	0	0	0	0
Total Exports	669	669	585	585	642	595
TOTAL Exports	669	669	585	585	642	595
Human Dom. Consumption	1	1	1	1	1	1
Other Use, Losses	0	0	0	0	0	0
Total Dom. Consumption	1	1	1	1	1	1
TOTAL Use	670	670	586	586	643	596
Ending Stocks	53	70	118	70	118	60
TOTAL DISTRIBUTION	723	740	704	656	761	656
Calendar Yr. Imp. from U.S.	0	0	0	0	0	0
Calendar Yr. Exp. to U.S.	4	4	4	4	4	4

Trade Matrices

New Zealand Exports Butter			
	(Kilograms)		
Country	2002/03	2003/04	2004/05
Belgium	80,933,543	65,295,122	37,754,653
Denmark	5,237,300	35,846,631	32,792,160
United States	20,120,159	27,283,966	28,072,013
Russia	29,791,181	30,962,994	24,817,738
Iran	37,442,493	28,297,812	15,798,225
Egypt	29,548,380	21,498,365	15,300,000
Mexico	21,287,661	18,335,299	12,221,605
Taiwan	10,994,310	9,774,448	12,031,788
Total	369,839,576	374,804,235	295,962,485

New Zealand Exports Cheese			
	(Kilograms)		
Country	2002/03	2003/04	2004/05
Japan	39,262,390	48,880,269	55,405,137
Australia	39,612,130	35,555,045	37,206,948
United States	45,710,485	39,038,997	32,453,346
Korea, South	10,365,389	13,362,284	12,762,870
Belgium	29,513,146	20,624,355	12,710,375
United Kingdom	16,183,033	15,426,510	10,976,223
Mexico	13,859,673	13,618,557	10,713,150
Saudi Arabia	9,240,641	9,579,399	8,907,921
Total	278,702,014	277,867,998	259,332,529

New Zealand Exports Non-Fat Milk Powder			
	(Kilograms)		
Country	2002/03	2003/04	2004/05
Philippines	37,451,827	46,016,109	47,939,509
China	22,095,991	25,321,000	22,495,066
Malaysia	22,897,388	32,393,609	20,132,061
Thailand	19,999,048	21,691,600	16,875,685
Saudi Arabia	13,641,375	11,908,225	15,665,850
Indonesia	21,819,564	16,043,361	13,446,502
Japan	21,174,590	14,212,779	12,692,013
Singapore	13,139,079	11,890,769	12,512,123
Total	305,973,636	305,022,840	221,088,520

New Zealand Exports Whole Milk Powder			
	(Kilograms)		
Country	2002/03	2003/04	2004/05
China	78,442,924	91,054,915	63,079,135
Saudi Arabia	30,037,950	38,071,375	54,291,625
Sri Lanka	32,501,947	42,808,797	45,287,315
Indonesia	42,608,635	24,675,414	33,207,590
Malaysia	47,840,284	51,640,365	32,908,799
Philippines	37,931,939	30,153,053	32,580,877
Mexico	30,372,628	39,037,112	29,342,345
Venezuela	27,350,575	44,971,800	27,898,400
Total	613,783,650	669,216,575	585,370,554

SECTION III. PRODUCTION AND MARKETING

PRODUCTION

New Zealand's milk production during the 2005/06 season (June-May) is now estimated at 14.9 million tons, 800,000 tons above our initial forecast and 3 percent higher than the previous season. Post's estimate of New Zealand's dairy herd at the beginning of the 2005/06 season has been adjusted up to 4.1 million cows and heifers in calf or milk, a 3 percent increase over the previous season.

The 2005/06 season was negatively affected by weather conditions. Production per cow was at a similar level to the previous season, which recorded a large drop in production from previous years. Milk production varied across New Zealand, with the most pronounced affect in parts of the North Island. The 2005/06 season started out strong, with milk production well ahead of the previous season. But during October 2005, 2 weeks of unseasonably cold weather caused milk production to plateau soon before what should have been the season's peak flow, greatly reducing total milk production. Production was steady for the remainder of the season, but was again negatively affected in March 2006, when unseasonably dry weather reduced milk flows. This decline in production per cow was offset by a 3 percent increase in cow numbers. As a result, milk production almost reached that of the record 2003/04 season.

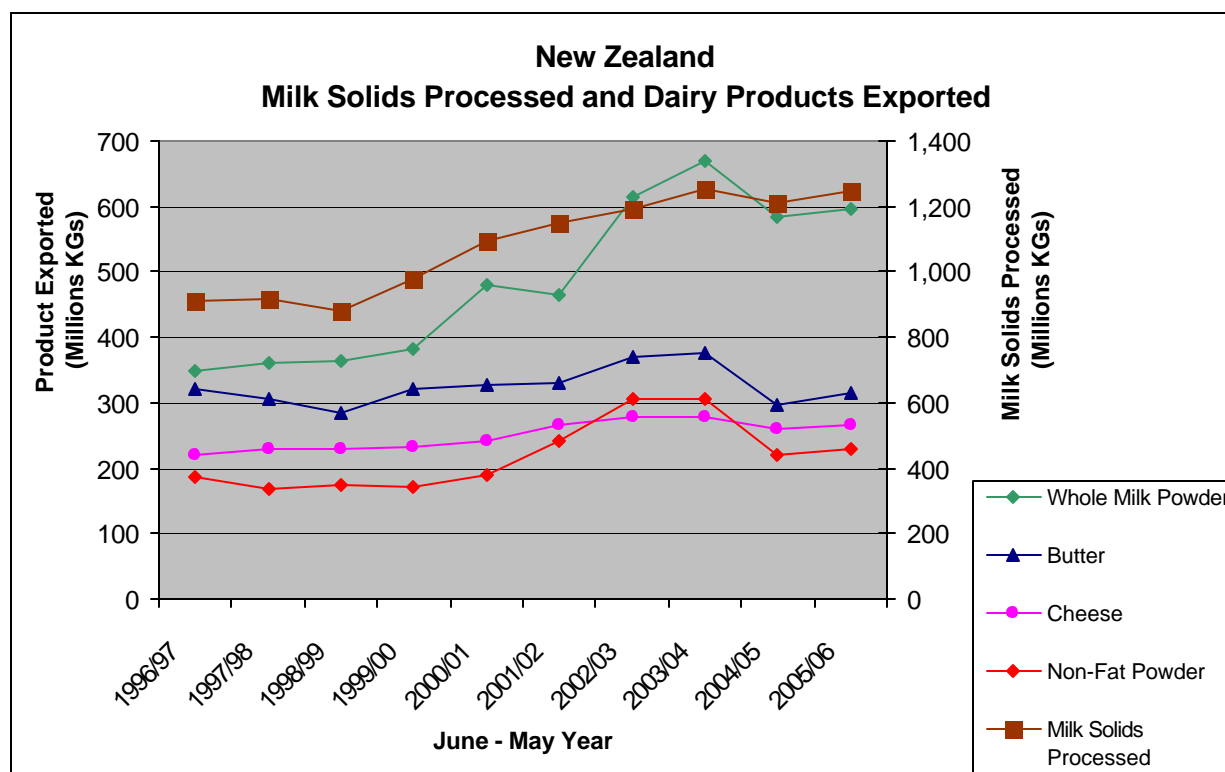


Table 1: Milk Solids Processed and Dairy Products Exported (2005/06 is a forecast).

Trade

As can be seen from table 1, exports of milk powder (both whole and non-fat) increased significantly during the 2002/03 and 2003/04 seasons, as did butter to a lesser extent. This spike in exports came despite milk volume increasing at a much lower rate, inline with previous years. This is a result of Fonterra clearing inventories during those seasons (see

NZ4019). Exports during the 2004/05 and forecast 2005/06 seasons returned to sustainable levels. Production and inventory levels in the PS&D tables have been recalculated due to new information. Production and inventory data are only estimates, however, as this information is not publicly available.

Table 1 also reveals New Zealand's rapid increase in whole milk powder exports during the past 10 years, taking a large share of the growth in New Zealand's milk production. This reflects the large investment Fonterra continues to make in powder production (see NZ3019 and NZ4019). The majority of New Zealand's whole milk powder is exported to Asia, with more than 10 percent of production sent to China alone. Other commodities have grown, but at a much lower rate.

Butter

New Zealand's butter production is forecast to increase 6 percent to 340,000 tons. Exports are forecast to increase 6 percent to 315,000 tons for the 2005/06 season. Note that butter figures include anhydrous milk fat.

Cheese

New Zealand's cheese production for the 2005/06 season is forecast to remain at 290,000 tons. Exports will also remain the same as the previous season at 265,000 tons.

Non-Fat Dry Milk

Non-fat dry milk powder (skim milk powder) production in New Zealand for the 2005/06 season is forecast to increase 4 percent to 234,000 tons. Exports are forecast increase 4 percent to 230,000 tons.

Full Fat Dry Milk

New Zealand's full fat dry milk (whole milk powder) production is forecast to remain at 585,000 tons in the 2005/06 season. Exports are forecast to increase 2 percent to 595,000 tons.

MARKETING

Fonterra's International Operations

Fonterra continues to invest in increasing the rapid growth of demand for its dairy products in Asia. It is doing so by promoting dairy foods as a health supplement and adapting products to the Asian palate. Examples of this include a traveling bus with the capability to measure the bone density of potential consumers to promote dairy products as a health food. Another is the development of new flavors for the Asian market, such as chocolate flavored cheese and green tea flavored milk.

The Chinese government approved Fonterra's application to purchase a 43 percent share of Chinese dairy company San Lu in April 2006. Fonterra views partnering with a local company as an assist in capturing a larger share of China's rapidly growing demand for dairy products. It also believes that gaining access to fresh milk supplies will complement its existing importing and consumer businesses.

A proposed joint venture between Fonterra and Campina, a Dutch dairy company, was announced in March 2006. The joint venture will focus on improving the pharmaceutical lactose specialty of both companies. The two companies will benefit from Campina's strong presence in Europe and Japan and Fonterra's strong presence in the Asia-Pacific region. The

joint venture will own and operate existing manufacturing plants in New Zealand, the Netherlands and Germany presently owned by the two partners.

Fonterra and Dairy Management Inc (DMI) have signed a joint research agreement to promote the health and nutritional benefits of dairy. The research will help create competitive advantage for dairy products over competing protein based products and substantiate product claims. DMI is a U.S. organization that builds demand for U.S. dairy products and represents the American Dairy Association, National Dairy Council and the U.S. Dairy Export Council.

Fonterra's Domestic Expansion

In November 2005, Fonterra announced that it had reached an agreement with Foodstuffs to purchase Kapiti Fine Foods, subject to approval from the New Zealand Commerce Commission. In February 2006, the Commerce Commission granted approval for the sale. Fonterra paid NZ\$ 169 million (U.S.\$ 120 million¹) for Kapiti Fine Foods. This includes a 10 year contract to supply Pam's branded milk to Foodstuffs lower North Island supermarkets. Kapiti Fine Foods has an annual turnover of NZ\$ 60 million (U.S.\$ 40 million) a year and is best known for its Kapiti branded ice cream and cheese aimed at the premium market niche. This is part of Fonterra's strategy to invest in branding value added dairy foods and it plans to expand sales of Kapiti branded premium product into export markets.

Increases in Fonterra's Domestic Competition

Although Fonterra retains control of 95 percent of New Zealand's milk supply, opportunities to supply competitors is increasing for farmers in some areas. No competitors source milk nationally, instead purchasing milk from farmers close to their plants in an effort to control costs. Two notable small businesses have been created during the last two years (see NZ5007). Although the volume processed by these businesses will be insignificant compared to Fonterra's production and that of the other cooperatives, Tatua and Westland, their creation is significant, as Fonterra has had limited domestic competition for milk supply since its creation. These small businesses will aim for niche markets, in particular those that Fonterra considers too small to target.

Open Country Cheese will triple its suppliers to 70 dairy farms in the 2006/07 season. The majority of these farmers will stop supplying Fonterra to do so. Open Country Cheese began operations during the 2004/05 season and is planning to continue expanding. Currently the company is assessing whether to invest in a milk powder plant. New dairy company Synlait was given resource consent in April 2006 to build its powder factory on the Canterbury plains in the South Island. Synlait plans to have the plant operational for the 2008/09 season and will process 200 million liters of milk annually.

Fonterra will have an additional small advantage over domestic competitors eliminated as its monopoly on export quotas are phased out between 2007 and 2010. This includes cheese subject to quota to the U.S., as well as butter and cheese to the EU, butter to Canada, cheese and animal fats to Japan and whole milk powder to the Dominican Republic. A yet to be decided system will be created to allocate the licenses as Fonterra loses control of them.

Fonterra Farmer Payouts and Share Value

Fonterra's forecast payout was increased in April 2006 to NZ\$ 4.07 per kilogram of milk solids for the 2005/06 season. Fonterra stated that cost cutting and the weakening of New

¹ Exchange rate 2005: U.S.\$ 1 = NZ\$ 1.42

Zealand's currency against the U.S. were contributing factors to the increase over the initial forecast of NZ\$ 3.85. The benefit of New Zealand's depreciating currency is delayed due to Fonterra's extensive forward currency hedging, and will have a larger impact on next season's payout. Forward contracts with customers will also lock in revenues on a large amount of product. The forecast payout for 2005/06 is well below the final payout for the previous season of NZ\$ 4.59.

In December 2005 Fonterra announced its fair value share price for the 2006/07 season at NZ\$ 5.86. This is an 8 percent increase over the 2005/06 season's NZ\$ 5.44 share price. Fonterra's share price is determined by a neutral third party who assesses Fonterra's current value and its long-term prospects. This has been a source of contention in the industry as the share price is based on a large amount of private information and does not reflect market perceptions (see NZ5007).

Fonterra's Capital Structure

Two changes in Fonterra's capital structure were introduced in the 2005/06 season (see NZ5007) – the introduction of contract milk supply and the elimination of peak notes. There has been limited uptake of contracts for the 2006/07 season, totaling 0.5 percent of Fonterra's total New Zealand milk supply. Fonterra expected the minimal contract supply in the first season this option was offered. The 2005/06 season is the first where a capacity charge system is implemented in place of peak notes. Farmers that produce a high 'peak' milk flow will now have their payout reduced, rather than having to purchase peak notes, as under the old system.

Private Equity Group Offers Loans on Shares

A private equity group, Dairy Investment Fund Limited (DIFL), is offering to lend New Zealand dairy farmers the value of their investment in Fonterra. As Fonterra is a cooperative, it is mandatory for farmers to own an amount of shares in Fonterra that corresponds to the volume of milk solids they supply annually. In exchange for the loan, the equity group will receive the value-added share of the milk price (the difference between the commodity milk price and the actual price paid by the cooperative to farmers), as well as increases in the value of the shares. Farmers will receive the commodity milk price and use the capital for alternative investments. Farmers retain ownership of the shares and voting rights. The company has plans to expand the scheme to farmers with shares in other cooperatives, such as Livestock Improvement and Westland Dairy. The introduction of this initiative reflects the unhappiness of some Fonterra suppliers with the cooperative's current share structure and consistently increasing share price, increasing the difficulties of expanding or creating new farming operations.

DIFL is also offering a milk price derivative. Farmers have the opportunity to enter into a contract with DIFL at the beginning of the season at a set price for the final payout per kilogram of milk solids. If the payout is lower than the contract between DIFL and a farmer, DIFL will pay the difference. If the payout is higher, the farmer pays DIFL the difference.

New Dairy Industry Body

Dairy 21 was created in late 2005 as a dairy industry body with the aim to increase the productivity of New Zealand dairy farms by 4 percent per annum. The aim of the group is to identify important objectives for New Zealand's dairy industry so they can be targeted in a consistent manner industry-wide. Dairy 21 has also approached the New Zealand government for more funding for research in the dairy sector. Dairy 21 currently has no direct funding – membership is voluntary and these organizations have covered their own

costs to date. The members of Dairy 21 include Dexcel, AgResearch, Livestock Improvement Corporation, Fonterra, Westland Milk Products and the Dairy Companies Association of NZ. Dairy InSight was originally part of this group, but decided that it needed to remain independent as it collects and distributes a research levy paid by dairy farmers.